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An Agricultural Law Research Article

Legal and Policy Considerations of Investor-Friendly Cooperatives

by

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Introduction

Farmers and rural communities have looked to the cooperative model for over 150 years as an organizing principle for decision making, profit sharing, and education. As the economic environment has changed, coops have evolved in attempts to meet competition and fulfill their members' needs. In recent years a new model has emerged that has become known as the Minnesota model. Minnesota authorized this new type of coop in 2003, with Wyoming and Tennessee adopting similar measures and about 12 other states considering legislation.[1] The National Conference of Commissioners on Uniform State Laws is also in the process of drafting a uniform law that has some similar features. The main distinction of these new coops is that they allow people who previously were not allowed membership rights, specifically mere investors, to have voting rights in the coop. The overriding goal of this new type of coop in the agriculture context is to allow these entities to attract more investment in relatively capital- intensive processing ventures.

This article examines some of the traditional cooperative principles and how state policy makers have manifested those principles by enacting laws allowing for the incorporation of cooperatives. It then discusses some of the evolving demands on cooperatives and how policy makers have responded, specifically with the enactment of the Minnesota statute that creates investment coops and the consideration of a uniform law that will create investment coops. Finally, the article examines how these new coops will be treated under certain federal statutes, such as the Capper-Volsted Act, the Securities Exchange Act, the Internal Revenue Code and the Farm Credit Act.

Traditional Cooperatives

Since the founding of the first modern cooperative by the Rochdale Pioneers in the middle of the 19th century, commentators have defined coops in various ways.[2] In 1965, the USDA Farmer Cooperative Service defined coops this way:

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[1] Amy Gunderson, *The Lowly Coop Gets a Makeover*, INC., Aug. 2004.

[2] James R. Baarda, Introduction to U.S. Farmer Cooperatives, 12-14, Fall 2004 (unpublished class materials on file with the author) (listing six different definitions from academic or government sources dated from 1937 to 1973, all of which generally agree with the definition provided in the text by the USDA Cooperative Service. EVANS & STOKDYK, THE LAW OF AGRICULTURAL MARKETING (1937); United States Government Printing Office, *Report of the Inquiry on Cooperative Enterprises in Europe* (1937); Fetrow &Elsworth, *Agricultural Cooperation in the United States*, Farm Credit Admin. Bulletin No. 54 (1947); PACKEL, THE ORGANIZATION AND OPERATION OF COOPERATIVES (1970); Schars, *Cooperative Principles and Practices*, University of Wisconsin Extension (1973)).

A cooperative is a voluntary contractual organization of persons having a mutual ownership interest in providing themselves a needed service(s) on a nonprofit basis. It is usually organized as a legal entity to accomplish an economic objective through joint participation of its members. In a cooperative, the investment and operational risks, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative's services. A cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the cooperative.[3]

In a more recent statement of cooperative principles, USDA's Rural Business-Cooperative Service prepared a comprehensive report in 2002 entitled *Agricultural Cooperatives in the 21st Century* that set out the three major cooperative principles:

The User-Owner Principle. The cooperative is owned by the people who use it.
The User-Control Principle. The cooperative is controlled by the people who use it.
The User-Benefit Principle. The benefits generated by the cooperative accrue to its users on the basis of their use.[4]

In an effort to further these principles and to facilitate the proliferation of coops, state and federal legislative bodies have passed a series of laws. In general, states pass laws that allow the incorporation or formation of cooperatives if this new business organization meets certain restrictions that carry out the cooperative principles. State laws can be very prescriptive in matters such as who can be a director, the directors' powers, distribution of earnings, and how the coop is dissolved.[5] One treatise estimates that in the United States, 90 different state statutes provide for the incorporation or regulation of cooperatives, with many of the states having different statutory provisions for agricultural cooperatives as opposed to coops in general.[6] Traditional state laws generally manifest the cooperative principles by delineating that the owners must use, control, and benefit from the enterprise.

State Law

Traditional cooperative statutes have been protective of the idea and term "cooperative." For instance, the Minnesota traditional cooperative statute defined "cooperative" as "an association conducting business on a cooperative plan that is organized under this chapter or is subject to this chapter."[7] The same chapter prohibits any firm from representing itself as a cooperative unless it is organized under the traditional cooperative statute.[8]

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[3] Savage & Volkin, *Cooperative Criteria*, FCS Service Report 71, Farmer Cooperative Service (1965).

[4] RURAL COOPERATIVE BUSINESS SERVICE, AGRICULTURAL COOPERATIVES IN THE 21ST CENTURY, (Cooperative Information Report No. 60 , 2002) (hereinafter RCBS). This report stated that "[o]nly an enterprise conforming to the spirit and intent of this definition should be labeled a cooperative."

[5] For a summary of most of the agricultural cooperative statutes, see TERENCE J. CENTNER, AGRICULTURAL LAW § 131.08 (Neil E. Harl ed., 2004).

[6] *Id.* § 131.01[1].

[7] MINN. STAT. ANN. § 308A.005(5) (2004).

[8] MINN. STAT. ANN. § 308A.011(1) (2004). It is unclear how this prohibition extends to the new 308B coops. If it does apply to 308B coops, a firm organized under 308B is known as a coop for legal purposes, 308B.005(9) but

Cooperative statutes have different ways of implementing cooperative principles. From the first cooperative statute in 1865, to Wisconsin's influential 1911 Act, to the Standard Act that swept through nearly every state legislature in the 1920's,[9] to some of the newer cooperative laws of today, policy makers have chosen many different ways to express what they perceived to be cooperative principles.[10] Some of the principles have consistently and clearly found expression in the state statutes, while others are more subtle and have been variously implemented over time and across different states. Certain laws seem to abrogate the responsibility of upholding the principles to the articles of incorporation or the bylaws,[11] raising interesting questions of whether the laws really require an adherence to cooperative principles or rather just allow it.

User-Control Principle

The user-control principle is easily recognized in many state coop statutes, primarily through one of the most distinctive features of coop statutes, the one-member one-vote requirement.[12] Although many variations exist to this rule, including voting rights being based on how much a person uses the cooperative, cooperative statutes rarely allow voting based on the amount of capital invested.[13] Typical statutory language states: "No member may own more than one membership or share of common stock. Each voting member shall be entitled to one vote and no more at all corporate meetings."[14] This voting right is probably most important in the selection of the directors,

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will not be able to use the term cooperative "as part of its corporate or business name or title, or to represent itself as a cooperative." *Id.* § 308A.011(1).

[9] JAMES R. BAARDA, COOPERATIVE PRINCIPLES AND STATUTES: LEGAL DESCRIPTIONS OF UNIQUE ENTERPRISES 2-9 (Agricultural Cooperative Service Report No. 54) (Mar. 1986). This excellent analysis and annotation "traces cooperative principles' development and their present status, traces incorporation statutes' developments and their present status, then analyzes statutory rules to demonstrate the inseparable combination of principles and law." *Id*. at i. Although written nearly 20 years ago, the analysis is still sound, given that up until the last few years there had not been any widespread movement to reexamine cooperative law in the interim.

[10] The degree to which cooperative statutes "purely" implement cooperative principles varies. A recent USDA report explains that "[e]ach principle can be viewed as one end f a continuum or spectrum. Any movement away from the pure application of the principles places the organization in jeopardy of compromising its cooperative identity." RCBS, *supra* note 4, at 2. Given the infinite gradations of how a firm can be organized and function, "[i]t is difficult to identify precisely where the lines are crossed that move the organization from being a cooperative to being another type of organization." *Id.*.

[11] Beyond meeting the requirements of the state statute, many laws require that the firm operate under a cooperative plan. *See e.g.* MINN. STAT. ANN. § 308A.005(5) (2004) ("Cooperative means an association conducting business on a cooperative plan that is organized under this chapter or is subject to this chapter."). Yet the term cooperative plan is not defined in most statutes. The draft uniform Agricultural and Agricultural Related Cooperatives Act states in its preliminary comments that "the definition of 'Cooperative' requires activity 'pursuant to a cooperative plan.' 'Cooperative plan' has intentionally been left undefined based on committee discussion. The term 'cooperative plan' appears in other cooperative acts without definition but acting in conformity with a cooperative plan is required for definitional purposes in other law. Thus, a plan is a basic cooperative notion that is not defined or described in this draft." Uniform Act, *infra* note 56, preliminary comments to § 102. *Cf.* Baarda, *supra* note 12, at 14 ("As a practical matter, membership restrictions are usually placed in bylaws.").

[12] Baarda, *supra* note 12, at 22 (annotating statutes that support his statement that "[55] statutes in 36 States limit individual cooperative members' voting power to one vote per member regardless of equity invested in the cooperative.")

[13] *Id.* at 24.

who will likely make most of the key decisions of the coop involving the direction of the business and key personnel. This dynamic assures that the directors represent the interests of individuals as opposed to blocks of capital. Some statutes and bylaws proscribe that directors' seats will correspond to the geographic division of the cooperative area served to assure that certain areas are represented.[15] Many cooperative statutes also provide that members have greater participation rights than many non-cooperative firms. These participation rights involve such things as "regular member meetings, special meetings, referenda, and books and records available to the members."[16]

User-Benefit Principle

The user-benefit principle is also easily recognizable. Most cooperative statutes require that the cooperative distribute most of the profits and limit the amount of profit that a cooperative can reserve for itself.[17] In general, these distributions can be patronage refunds based on how much business the farmer did with the coop[18] or dividends based on the amount of investment in the coop. With the user-benefit principle in mind, most statutes limit the amount of dividends that can be paid to eight percent of the stock's value.[19] For instance, the Iowa cooperative statute provides that neither common stock (membership stock) nor preferred stock[20] (non-membership stock) may earn dividends greater than eight percent.[21]

User-Owner Principle

The most difficult of the three cooperative principles to divine from state statutes is the user-owner principle. Many state statutes limit the occupation of the members to farmers or agricultural producers[22] and thus necessarily limit the pool of people eligible to those who could possibly use the coop and own the common stock.[23] But most statutes allow non-patrons to own preferred stock, with

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[14] IOWA CODE ANN. §499.28 (2004).

[15] Baarda, *supra* note 12, at 27.

[16] *Id.* at 33.

[17] *Id.* at 42.

[18] The mechanisms to pay out patronage refunds prescribed or authorized by cooperative statutes varies widely, but in general usually refer to the amount of business done with the cooperative. *Id.* at 42-46.

[19] *Id.* at 46 ("A majority of statutes limit dividends or "interest" paid on capital stock. Limits may apply to common stock, preferred stock, or (rarely) to patronage-based equity. Fifty-five statutes place a definite maximum limit on the amount of interest or dividends … that may be pad on common or membership stock.").

[20] *See* James R. Baarda, "Outside" Cooperative Equity: Obligations, Tradeoffs, and Fundamental Cooperative Character 3-4, Paper Presented at the NCR-194 Conference (Nov. 2004) (on file with the author) ("[P]referred stock carries no voting power other than that commonly assigned in corporate change situations (merger, dissolution), has a set rate of dividend established by terms of the stock ownership, dividends are payable prior to patronage refund allocation, the stock is callable by the cooperative under specified terms but stockholders cannot force redemption, and the stock is tradeable without restriction.")

[21] IOWA CODE ANN. §§ 499.23 and 499.24 (2004).

[22] "Restriction on incorporators is exemplified by the Standard Act statement a cooperative may be organized by persons 'engaged in the production of agricultural products.' Forty-nine statutes (representing 40 States) contain a similar or identical restriction." Baarda, *supra* note 12, at 14 (annotating the states that have the similar restrictions).

some allowing 100 percent ownership by nonpatrons.[24] Nevertheless, many of the statutes discourage non-user ownership with the statement that "[a]ssociations organized hereunder shall be deemed 'nonprofit' inasmuch as they are not organized to make a profit for themselves, as such, or for there members, as such, but only for their members as producers."[25] This non-investment idea is woven throughout the other principles to result in the user-owner principle.[26] With provisions that implement the other principles (user-control and user-benefit), the user-owner principle results because the control and dividend restriction discussed above result in only users – as opposed to investors – wanting to become owners. To put it another way, if someone does not have the ability to gain competitive dividends or to have voting rights equal to their investment, that person will not want to become an owner of the enterprise merely as an investment exercise.

Changing Conditions Affecting the Viability of Coops

As all participants in agriculture in recent years, cooperatives have had to adapt to the changing landscape. The following list of external forces affecting cooperatives is taken from USDA reports and recent studies of cooperatives:

Changing Farm Demographics

In the United States, cooperative policies have chiefly been designed to serve mid-sized family farms, an admittedly hazy term that for purposes of this article includes farms that rely on the farm for their primary income but are still relatively small with less than $250,000 per year.[27] This demographic of 'intermediate' sized farms continues to dwindle and in 2002 only accounted for about 30 percent of the farms in the country and provided about 24 percent of the agricultural products.[28] In another example citing the 2002 Agricultural Census, the number of Iowa farms with sales of between $5,000 and $500,000 dropped by five percent in five years, while the very large farms, those with sales of greater than $500,000, grew by 17 percent.[29]

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[23] *E.g.* IOWA CODE ANN. § 499.13 (2004) provides: "A membership or share of common stock shall not be issued to, or heldby, any person unless the person is eligible for membership in the association under its articles. A person may be eligible only if the person is engaged in producing a product marketed by the association, the person customarily consumes or uses the supplies or commodities that the association handles, or the person uses the serviceds that the association renders.

[24] Tom Bengtson, *The Latest New Generation Cooperatives*, N.W. FIN. REV., Nov. 1, 2003. In response to critics who have raised concerns about non-patron ownership of the coop, the chief author of the Minnesota statute, Mark Hanson, who is an attorney in Minneapolis, stated that they are overreacting. *Id.* He pointed out that outside investment was possible under the traditional Minnesota cooperative statute and that "'[u]nder many of the corporate cooperative statutes, a cooperative can be financed by 100 percent non-patron investment and under the commodity marketing act statutes, preferred stock can have voting rights.'" *Id.*

[25] Baarda, *supra* note 12, at 18; *see e.g.* CAL. CORP. CODE § 12201 (West Supp. 2004).

[26] *See* MAHLON G. LANG, STRENGTHENING AGRICULTURAL COOPERATIVES: AN INQUIRY INTO EXPERT BELIEFS 11 (Center for Cooperatives, U. of Cal., Davis 2002). Lang explains that "[a] direct result of the 'user benefit' principle is the fact that cooperatives return benefits (earnings, market access, or other services) in proportion to patronage of the cooperative. As a result, there is no incentive for non-patrons to provide true risk capital to a cooperative, *as a cooperative*." *Id.* (italics in original, footnote omitted).

[27] RCBS, *supra* note 4, at 3

[28] RCBS, *supra* note 4, at 3.

The trend is clear. The disappearance of smaller and middle-sized farms, with the land yielding to the very large farms, has two implications for cooperative policy. The first is a simple challenge of numbers and the dwindling pool of possible members for the cooperatives. The second concerns whether cooperative policy still serves the agricultural industry as it exists today.[30] If most of cooperative policy was designed to serve a large number of smaller farmers, is it effective in serving a smaller number of larger farmers? At any rate, people can certainly agree that this fundamental change in the demographic of those who use, own, and control coops would exert significant pressure on cooperative policy.

Technological Innovation[31]

Technological developments continue to exert pressure on cooperative policy. Much of production agriculture today relies on technology that involves a high degree of research and development and the creation of intellectual property. Whether it is genetically modified seeds, computer software or a new breed of livestock, farmers are less likely now than before to have public access to new techniques that they may need to remain competitive. In earlier days, farmers were able to access much of the latest technology through public institutions, chiefly the land-grant colleges.[32] Now farmers are more likely to be required to pay some type of licensing fee to use certain technology[33] that can be quite high, a fact that the owners of the intellectual property justify by pointing to the high costs of research and development.

Some farmers may look to their cooperatives for help with the costs related to this new dynamic by either having their coop develop the new technology or providing the coop the ability to reap the value associated with the intellectual property by specially processing the good. Either of these goals calls for a much greater infusion of capital then the traditional cooperative model. Although the story of American agriculture has always included a basic thread dealing with technology, the present heavy reliance on technology in agricultural has put pressure on the cooperative policy to adjust to the new environment.

Role of the Consumer[34]

Many analysts suggest that the consumer sector, as opposed to the production or processing sectors, is the most powerful in the broader agricultural and food industry.[35] With increased access to

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29 Leopold Center for Sustainable Agriculture, *Serious Concern About Farm Community's 'Disappearing Middle' Sector*, Feb. 9, 2004, http://www.leopold.iastate.edu/news/newsreleases/2004/middle_020904.htm.

30 RCBS, *supra* note 4, at 3.

31 *Id.*

32 *Id.* at 4.

33 USDA Economic Research Service, *Agricultural Biotechnology Intellectual Property*, http://www.ers.usda.gov/data/AgBiotechIP/ (viewed Jan. 25, 2004) ("As the pace of scientific discovery in agricultural biotechnology has accelerated over the past few decades, the use of patents and other intellectual property rights to protect these discoveries has increased tremendously.").

34 RCBS, *supra* note 4, at 4;

35 Suzanne Thornsbury & Gary Fairchild, *King or Pawn: Consumer Preferences in International Trade,* CHOICES (1st Quarter 2004) available at http://www.choicesmagazine.org/2004-1/2004-1-07.htm. (pointing out that international trade and business management literature have traditionally pointed to consumers as the driving force in the economy).

information that accompanies the proliferation of the Internet and other digital and electronic media, the power of the consumer has increased.[36] With a renewed interest in such things as sustainably-raised food and an increased ability to trace food, new opportunities have arisen for farmers and food processors.[37]

Most cooperative policy was not designed to cater to this new dynamic. Cooperatives may be poised to capture some of this untapped market because consumers may value such things as the closer relationship that a cooperative may offer between consumer and producer. Cooperatives by their very nature are relatively more producer-oriented than other corporate forms. Yet some cooperative policy may hinder farmers' ability to react to this trend because to tap the market, the firms may need to have increasingly complex marketing departments to reach these sometimes hard-to-find markets[38] and an ability to efficiently trace the food. Generally, larger, well-capitalized, vertically-integrated firms are better able to do these types of activities.

Industrialization[39]

As stated by the USDA Economic Research Service, "[i]ndustrialization of agriculture is commonly associated with a shift toward: (1) A greater reliance on contracting and vertical integration in the food and fiber system; (2) Increased specialization of farm activities, which results in increased use of purchased inputs; and (3) Larger farms, measured in terms of acreage or (preferably) sales."[40]

Industrialization is usually explained as the result of an attempt by a particular firm for greater efficiency and a higher degree of control of more of the production and processing chain. The most-cited example is how the poultry industry developed in the middle of the 20th century so that nearly all of the major production decisions (genetics, nutrition, environment) is decided by the same firm that owns and processes the chickens.

The move toward industrialization has two major impacts on cooperatives. First, because industrialization tends to narrow open markets and horizontally consolidate firms within an industry, cooperatives are called on to exercise their role of strengthening farmers' bargaining power relative to the integrated firms. With their open markets becoming thinner and even fewer buyers of their commodities, farmers may need to rely more on cooperatives to provide real competition in the market. Second, in an effort to compete with firms who have vertically integrated, some larger coops have adopted the strategy and attempted to vertically integrate by contracting with their members for the production of commodities that are either owned or controlled by the coop.[41] In some ways, cooperative policy was designed specifically for the effects of industrialization. It provided a means for farmers to join together to market their goods in an effort to increase their bargaining power. Some observers, however, suggest that farmers should be given the opportunity to participate in the

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[36] RCBS, *supra* note 4, at 5.

[37] *Id.*: "To gain consumer acceptance and loyalty, cooperatives must 'unlock' value in their commodities through differentiation. For example, this might involve highlighting specific physical attributes preferred by some consumers, such as organic, free-range, sustainable, fairly traded, humanely slaughtered, etc."

[38] *Id.* at 5.

[39] *Id.*

[40] USDA Economic Research Service, *Briefing Room on Farm Structure*, http://www.ers.usda.gov/Briefing/FarmStructure/glossary.htm#industri.

[41] RCBS, *supra* note 4, at 6.

industrial model as owners of the integrated firms, not just as contracted growers. Cooperative policy was not traditionally designed to meet this goal.

These factors have lead many observers to call for cooperatives to capture more of the food dollar for its members by getting in the business of processing their products.[42] These types of ventures usually take a greater amount of capital than a traditional marketing cooperative, sometimes much more capital. As discussed earlier, traditional cooperative statutes were not designed to make the coop an attractive investment vehicle; rather, cooperative policy was usually designed to carry out the overall cooperative principle of providing benefits to users, as opposed to investors. In response to this divergence, some in the coop community began to look for ways to attract more capital to cooperative ventures and to provide cooperative more flexibility in their capital formation.[43]

Policy Makers' Response

The Minnesota Model

In 2002, the Minnesota Association of Cooperatives (MAC) explored the idea of a new cooperative statute in a series of meetings across the state.[44] Noting the difficulties that some cooperatives have had in attracting capital, the members encouraged MAC to pursue the new legislation. Primarily in response to MAC's activities, in 2003 the Minnesota legislature adopted legislation known as chapter 308B authorizing the formation of a new type of business organization that melded some of the traditional cooperative notions with features that make the firm more attractive to non-patron investors. The statute does this by allowing non-patron members significant but limited voting rights and providing that their equity investment may earn a competitive dividend.[45]

As for voting, the notion of one-member, one-vote is replaced by bifurcated voting rights reflecting the fact that the firm is comprised of patrons and investors, with the possibility that investors may have as much as 85 percent of the vote on matters of the cooperative. Within the patron class, each member still has only one vote or his vote is based on patronage,[46] and the patron vote is voted as a block based on the majority of the patron votes.[47] The bylaws may not reduce the collective patron member vote to less than 15 percent of the vote.[48] The law leaves it to the firm's bylaws to

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[42] One executive from American Crystal, the large sugar cooperative, put it this way: "If you look at the brands backwards, you can see what is happening in the food industry and what's happening to farming. Farmers have to ask themselves if they want to just be farmers or if they want to be farmer-business people. If they want to stay a farmer, they will be growing crops under contract for someone else. If they decide to be a farmer-business person, they will be growing things for themselves." LEE EGERSTROM, MAKE NO SMALL PLANS 143-44 (1994).

[43] *See* Michael L.C. Cook & R. Fabio, *Redesigning Cooperative Boundaries: The Emergene of New Models* AM. 86 J. OF AGRIC. ECON. 1249 (Dec. 1, 2004) (providing a spectrum of different types of cooperatives based on "a broad definition of ownership rights comprising residual claim and control rights.").

[44] Bengtson, *supra* note 24.

[45] The dividends may exceed 6 or 8%, the traditional statutory maximum.

[46] MINN. STAT. ANN. §§ 308.545 and 308.551 (2004).

[47] *Id.* § 308B.545.

[48] *Id.* § 308B.545

determine the investor's voting rights; one would expect that most firms seeking to attract capital would base the amount of the non-patron voting rights on the amount of capital contributed.

As to the composition of the board, the law provides: "A majority of the directors shall be members and a majority of the directors shall be elected exclusively by the members holding patron membership interests unless otherwise provided in the articles or bylaws."[49] At least half of the voting authority of the directors shall be allocated to the directors elected by the members holding patron membership interests.[50] Because the members can be both patron members and non-patron members, and these "dual-function" members could serve on the board in either class, deciphering which interests will actually be represented is nearly impossible.[51] For example, a person who heavily invests in the firm but is also nominally a patron could be elected in the patron class of the directors, and his vote could count toward the 50 percent minimum of patron voting rights. This could be the case, even though his interests actually lie with his investment in, not his patronage of, the coop. Further, the election of this type of director is made all the more possible by the statute's provision that allows the bylaws to change the statutory recommendation that a majority of directors be elected by patron members,[52] which supposedly means that the articles or bylaws could prescribe that the minimal 50 percent of directors who must be patrons could be voted on, at least partially, by non-patrons.

The statute provides patron members the right to receive at least 60 percent of the profit allocations but makes a major qualification that the articles or bylaws may decrease the patron-share to as low as 15 percent.[53] Assuming that many of the firms that utilize 308B will do so in an effort to attract more capital from outside investors, it is highly likely that the patron members will find it necessary to maximize the amount of profit allocated to the investors and will utilize their statutory ability to restrict the patron-members share to less than 60 percent.

Not surprisingly, the passage of 308B has caused a debate between defenders of the traditional cooperative principles and those who seek more flexibility in the cooperative model. For example, one critic of the new model raised concerns that the dilution of ownership and control of the new entities will necessarily dilute the benefits to members.[54] While the proponents of 308B note that

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[49] *Id.* § 308B.411. Although the statute's proponents state that the law requires that no matter what, a majority of the directors shall be members, there remains an ambiguity as to exactly how the bylaws may affect these requirements. While it is clear that the bylaws may determine whether a majority of the directors need to be elected exclusively by members, but it is unclear whether the bylaws can override the statutory language requiring that a majority of the directors be members.

[50] *Id.* § 308B.411(2)(c).

[51] *See* Bengtson, *supra* note 24 ("Although patron-members are guaranteed 50 percent board representation, that assurance is skewed since member-patrons also can be investors, potentially giving investors majority control."); *see also* James R. Baarda, "Outside" Cooperative Equity: Obligations, Tradeoffs, and Fundamental Cooperative Character 4, Paper Presented at the NCR-194 Conference (Nov. 2004) (on file with the author) ("Where interests are in conflict but possessed by the same stakeholder, the individual stakeholder performs the task of balancing he interests, yielding decisions about his or her relationship with the cooperative given the stakeholder's aggregated set of objectives.").

[52] MINN. STAT. ANN. § 308B.411(2)(B) (2004).

[53] *Id.* § 308B.601(3).

[54] Bengtson, *supra* note 24. This same critic, Randall Torgensen, who at the time was a deputy in USDA Rural Business Cooperative Service, suggests that the new model veers so far from the traditional cooperative principles that the new model should not use the name cooperatives.

most cooperatives already have significant, if not majority, investment from non-patrons and that the statutory protections of board voting rights and minimum patron share of profits will protect the patron's interest.

Notwithstanding the debate on the degree to which the Minnesota model maintains the integrity of the traditional cooperative model, many other states have shown interest in the Minnesota model and have considered proposals similar to 308B.[55] The statute has even garnered interest by the National Conference of Commissioners on Uniform State Laws, which is currently drafting a law that incorporates a number of these new ideas, with the working title "Agricultural and Agricultural Related Cooperatives Act."[56]

Draft Uniform Law: Agricultural and Agricultural Related Cooperatives Act

Although this uniform law is still in the drafting stage, it is worth comparing some of its provisions with the Minnesota model. The language is based mainly on the Minnesota Cooperative Associations Act,[57] the Oregon Cooperative Corporations Act,[58] and the Model Business Corporations Act.[59] One of the obvious distinctions between the draft uniform act and Minnesota model is that while the Minnesota model applies to any type of business, the uniform act applies only to agricultural and agricultural-related cooperatives. For purposes of the uniform act, this generally includes: (1) livestock, crop, horticultural and aquaculture production; (2) the storage, provision, marketing and processing of agricultural products; and (3) "the provision of services and goods used in or helpful to agricultural production of any type."[60]

The draft uniform law attempts to maintain a strong member focus by doing such things as providing that the bylaws may be amended by members only, not directors.[61] The definition of members includes both patron and non-patron members. While the draft provides flexibility to attract non-patron investment capital, it does not go as far as the Minnesota model. The draft does provide for patron and non-patron membership interests.[62] As opposed to the Minnesota model that allows the bylaws to reduce the voting rights of patron members to a minimum of 15 percent of the total, the draft suggests that patron members retain at least two-thirds or three-fourths of the total voting rights.[63] As to profits, the draft provides: "[p]atron members shall be apportioned not less than 50 percent of the net proceeds, savings, or profits in any fiscal year but the articles of organization may

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[55] *See supra* note 1.

[56] AGRICULTURAL AND AGRICULTURAL RELATED COOPERATIVES ACT, prefatory note (Discussion Draft 2004) (hereinafter Uniform Act).

[57] MINN. STAT. ANN. § 308B (2004).

[58] OR. REV. STAT. ch. 62 (2004).

[59] MODEL BUSINESS CORPORATIONS ACT (2003).

[60] Uniform Act, *supra* note 56, § 102(1).

[61] *Id.* § 1302.

[62] *Id.* Article 4.

[63] *Id.* § 1302. In its preliminary comments to this section, the drafters recognize that the "quantum of voting reserved to patron members under Section 312(c) is controversial because it is a departure from the general law of cooperatives. It has been controversial in Committee discussion. It is also one of the primary changes that allows for greater flexibility for capital formation."

reduce the percentage apportioned to patron members to not less than 30 percent."[64] The Minnesota Model allows the articles or bylaws to reduce the profits to members to 15 percent.[65] The draft act represents a significant movement to reexamine cooperative policy in the states. Independent of how these states act on this interest, federal law will continue to play a major role in cooperative policy.

How Federal Law Might Treat 308B Cooperatives

One of the most important considerations that a group of farmers or others must make when contemplating what type of business form to take is how federal law will treat that business. This is important for any type of business organization – whether a traditional C-corporation, an S-corporation, a limited liability company, or even a sole proprietorship or partnership.[66] For most entities the overwhelming consideration in the federal policy is the federal tax system. This is also important for coops, but it is not the only consideration because cooperatives have garnered special treatment in a number of places throughout the United States Code.

The flexibility sought in the new cooperative statutes raises the possibility that new entities incorporated under the statutes may not receive the same treatment as traditional cooperatives. Many of the traditional state cooperative statutes, as indicated above, directly reflected the federal statutes so that any firm incorporated under the state statute would necessarily fit the federal requirements.[67] The Minnesota model and some of the other statutes depart from this approach and leave it in the discretion of the organizers whether they want to draft articles and bylaws that meet the requirements of the federal statutes.

Federal policy does not create cooperatives; rather, it states that if a business organization meets certain restrictions, then that firm will be treated in a special way under federal tax, antitrust, or other policy. Federal law does not care how the state categorizes a firm or what the firm calls itself. It only looks to the actual organization and operation of the firm. This article will touch on some federal statutes of special importance to cooperatives and how these statutes may treat the investor cooperatives different from the traditional cooperatives.[68]

Federal Antitrust Laws

Among other things, federal antitrust laws prohibit horizontal price-fixing.[69] Since 1890, the Sherman Act has prohibited individuals or firms that are competitors to agree on a certain price. In 1922, Congress passed the Capper-Volsted Act to encourage farmers to form cooperatives and

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[64] *Id.* § 804.

[65] MINN. STAT. ANN. § 308B.601(3) (2004).

[66] *See generally* Carol R. Goforth, *An Overview of Organizational and Ownership Options Available to Agricultural Enterprises: Parts I and II*, National Agricultural Law Center Research Article (2002), http://www.nationalaglawcenter.org/research/#ownership.

[67] For instance, "[m]any traditional state agricultural (and general purpose) cooperative statues 'hard-wire' compliance with Capper-Volstead by, for example, mandating the 8% dividend limit on equity." Uniform Act, *supra* note 56, prefatory note § 2.

[68] For an excellent discussion on possible pitfalls of investment-oriented cooperatives as they relate to federal law, see Christopher R. Kelley, *"New Generation" Farmer Cooperatives: The Problem of the "Just Investing" Farmer*, 77 N.D. L. REV. 185, 201-45 (2001).

[69] 15 U.S.C. § 1.

market collectively.[70] The Capper-Volsted Act only applies to farmers who would otherwise run afoul of the Sherman Act, that is, farmers who together agree to sell their products for a certain price. Although farmers in coops are free from the restrictions of the Sherman Act, the Capper-Volsted Act does limit farmers from unduly enhancing the price, as determined by the Secretary of Agriculture.[71] The Capper-Volsted Act effectively exempted farmers who are part of a coop from Sherman Act prosecution if those farmers organized their cooperatives in a certain way, specifically:

> First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein, or,
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> Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.
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> And in any case to the following:
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> Third. That the association shall not deal in the products of nonmembers to an amount greater in value than such as are handled by it for members.[72]

The Capper-Volsted Act raises immediate problems for farmer-groups organized as an investor cooperative. For instance, a coop organized under chapter 308B or the draft uniform law will likely include non-patron members who (1) have more than one vote because of their investment, and (2) own stock that provides a return of over eight percent. Further, the Act does not provide an exemption for organizations that are not wholly comprised of producers.[73]

Internal Revenue Code

Subchapter T

Subchapter T of the Internal Revenue code provides qualifying firms the significant advantage of being taxed either at the cooperative level or the member level, as opposed to the normal dual-level taxation of regular subchapter C corporations.[74] Subchapter T applies to any cooperative that meets the requirements of section 521[75] or to "any corporation operating on a cooperative basis,"[76] a phrase undefined in the code. This omission has left the courts and the Internal Revenue Service to determine the meaning of the phrase. While competing approaches exist,[77] one treatise summarized

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[70] 12 U.S.C. § 291. Congress passed the Act to extend and clarify an earlier farm marketing exemption, the Clayton Act. A.S. Klein, *Monopolies: Construction of § 1 of the Capper-Volsted Act …*20 A.L.R. FED. 924 (2004).

[71] 12 U.S.C. § 292.

[72] 12 U.S.C. § 291.

[73] Case-Swayne Co. v. Sunkist Growers, Inc., 389 U.S. 384 (1967) (holding that an association that included a relatively small amount of non-producers [around 5% of the total] could not qualify for the Capper-Volsted exemption).

[74] I.R.C. §§ 1381-88; *see* Kelley, *supra* note 68,at 211.

[75] *See supra* part 6.b.ii.

[76] I.R.C. § 1381.

[77] One "approach looks only to Subchapter T rules, with a focus on how the entity's net earnings are distributed or how its per-unit retains are allocated." Kelley, *supra* note 68, at 213 (citing JAMES R. BAARDA, UNITED STATES COOPERATIVES AND INCOME TAX POLICY 125 (1997) (unpublished manuscript, on file with Kelley)). The IRS, however, has generally embraced the "economic approach" to determine the meaning of "operating on a

the meaning of the "cooperative organization" "as one 'allocating amounts to patrons on the basis of the business done with or for such patrons' and not upon the basis of any financial investment by the patron."[78] Obviously, the non-patron members of an investor cooperative would take the firm out of the Subchapter T coverage and would cause the firm to be taxed as a normal corporation.

Section 521

One subcategory of coops has become known as "exempt"[79] or section 521 coops. The main advantage conferred to section 521 coops is that they are entitled to certain other deductions that are not available to subchapter T coops.[80] The qualifications for a section 521 coop are even more rigorous than a subchapter T cooperative. Among the numerous requirements, those that have special application to investor cooperatives include that if the organization has capital stock, the dividend must be fixed at a maximum of the state allowed interest rate or eight percent (whichever is greater) and that "substantially all of the stock, except non-voting preferred, must be owned by producers who market their products or purchase their supplies and equipment through the association."[81] This requirement has been interpreted to require that, as far as possible, the cooperative should ensure that those who purchase stock are producers.[82]

The investor coops would likely have trouble with both of these requirements because to attract capital, they would likely need to be able to provide dividends greater than eight percent. The other requirement listed actually goes against the very reason for the creation of the investor-coop statutes: the desire to raise capital from sources outside of the patron-membership base.

Securities Law

One of the main advantages of qualifying as a 521 coop is that such status exempts the firm from securities law. Federal law protects investors by requiring transparency in their investments. To

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cooperative basis." Kelley, *supra* note 68, at 213. The economic approach takes a look at the economic and operational principles of the cooperative and focuses on the "economic substance" of the cooperative. *Id.* at 215 (noting that the term comes from Land O'Lakes, Inc. v. United States, 514 F.2d 134, 139 (8th Cir. 1975). Writers usually cite an early Tax Court case as a core of the analysis:

> (1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.

Puget Sound Plywood v. Commissioner, 44 T.C. 305 (1965).

[78] Centner, *supra* note 5, at § 135.01[2][b] (quoting Treas. Reg. § 1.1381-1(a) and citing Etter Grain Co. v. U.S., 331 F. Supp. 283 (N.D. Tex. 1971)).

[79] For a discussion on the origins of the use of the word exempt and why it no longer applies (but nevertheless is still used), see Centner, *supra* note 5, at § 135.02[1].

[80] I.R.C. § 1382(c) (authorizing deductions for certain nonpatronage distributions).

[81] I.R.C. § 521(b)(2).

[82] Centner, *supra* note 5, at § 135.02[8] (citing Rev. Rul. 67-02 "which did not take the necessary steps to restrict stock ownership to producers when it issued common stock to retail patrons with a request that the stock be returned for redemption.").

qualify to sell securities, firms need to undergo rigorous registration and reporting requirements. In general, the Security Exchange Act of 1933[83] regulates the initial offerings of securities, and the Security Exchange Act of 1934[84] regulates the trading of securities. One commentator notes that registration can range between $200,000 and $500,000,[85] and this was before the new Sarbanes-Oxley Act, which requires even more rigorous paperwork requirements. To qualify for an exemption to the Act of 1933, the firm can qualify as a 521 coop.[86] The qualifications for an exemption to the Act of 1934 are a little less onerous, but practically just as difficult because that Act still requires one member, one vote or for the firm to limit its dividends, and that the firm must operate for the mutual benefit of its farmer members in the marketing of their products.[87]

Farm Credit Act

Another advantage that some coops enjoy is the ability to borrow from a lender that is part of the Farm Credit System. The Farm Credit System is the nation's oldest government- sponsored entity,[88] (GSE) which is "[a] n enterprise established by the federal government for a public purpose but privately owned and operated."[89] GSE's are usually able to charge lower interest rates because they are able to obtain money at below-market interest rates because "GSEs are recognized as being implicitly backed by the federal government although the federal government is not explicitly obligated."[90] The Farm Credit System in general was set up to provide greater access to capital for the farm sector. The Farm Credit System institution that has authority to lend to coops is called Cobank.

For a coop to be eligible to borrow from Cobank, it must be an association of farmers, ranchers, or aquatic producers, or a federation of these types of coops.[91] The coop must either follow the one member, one vote rule *or* it may not pay dividends in excess of what the Farm Credit Administration, the Farm Credit System regulator, allows.[92] In any case, the majority of patronage of

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[83] 15 U.S.C. § 77a to 77bbbb.

[84] 15 U.S.C. § 78a to 78lll.

[85] Kelley, *supra* note 68, at 223 (citing C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L. J. 591, 599 (1996)).

[86] 15 U.S.C. § 77c(a)(5).

[87] Centner, *supra* note 5, at § 136.02[2] (stating that to qualify for the exemption, the coop must meet the definition of cooperative association in the Agricultural Marketing Act of 1929, 12 U.S.C. § 1141 j(a)).

[88] *History of Cobank*, Cobank website at http://www.cobank.com/about/history.html.

[89] Chuck Culver, *Glossary of Government Agricultural Production, Programs, and Policy*, National Agricultural Law Center (4th ed.), *available at* http://www.nationalaglawcenter.org/#.

[90] *Id.*

[91] 12 U.S.C. § 2129 (a) provides: "Any association of farmers, producers or harvesters of aquatic products, or any federation of such associations, which is operated on a cooperative basis, and has the powers for processing, preparing for market, handling, or marketing farm or aquatic products; or for purchasing, testing, grading, processing, distributing, or furnishing farm or aquatic supplies or furnishing farm or aquatic business services or services to eligible cooperatives." *See also* 12 C.F.R. § 613.3100.

[92] Current regulations allow a maximum of ten percent or the maximum allowable rate under state law, whichever is less. 12 C.F.R. § 3100(b)(1)(iii)(B).

the coop must come from members, and not less than 80 percent of the voting control must held by farmers or eligible cooperative associations.[93]

These eligibility rules pose obvious problems for investor coops either in terms of voting control (both the one member, one vote rule and the minimum of 80 percent of voting control by farmers), or the limit on dividends. Cobank has been attempting to change the law so that it would be able to lend to investment coops, arguing that the lending institution designed to serve coops needs to keep pace with the evolution of the cooperative model.[94] Cobank's main competitors, the private lenders, have raised objections to the change in the law. Specifically, they argue that if Cobank were able to lend to the broader set of institutions, it "would dilute their existing obligations to farmer-owned and farmer-controlled cooperatives."[95]

In terms of policy debate on whether federal law should be amended to recognize investor coops, the most likely arena where it will occur is around the Farm Credit Act because in the lending area, those who champion changes to the law have a distinct organizational opponent, the private banking sector. In other arenas, whether it is antitrust, tax, or securities policy, there is not a distinct group that will be as directly affected by the expansion of the cooperative definition in federal law. In coop lending, however, those businesses not eligible to borrow from Cobank must look to the private banking sector for access to capital.

Conclusion

The passage of Minnesota's new chapter 308B and the consideration of the new uniform cooperative law reflect the significant interest in providing coops more flexibility to respond to a changing economic environment. To accomplish this goal, many suggest that the new type of cooperatives need to be able to attract more capital from outside sources. To do so, the new firms will need to be organized in a way that provides more benefits to investors. This goal, however, may go against the traditional notion that coops must be organized to benefit the users of the firm, not the investors. As the policy debate on the new investor coops continues, policy makers will need to ask themselves fundamental questions concerning the future of the cooperative model. In short, policy makers may need to see if it is possible to bring into line the new economic realities with the traditional cooperative principles.

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[93] 12 U.S.C. § 2129(a)(3) and (4).

[94] Bengtson, *supra* note 24.

[95] *Id.* (quoting Roger Monson, chairman of the American Bankers' Association Agricultural and rural Bankers Committee).